

ORIGINAL

OPEN MEETING AGENDA ITEM



0000163899

EXCEPTION

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH
Chairman

BOB STUMP
Commissioner

BOB BURNS
Commissioner

DOUG LITTLE
Commissioner

TOM FORESE
Commissioner

DOCKET NO. 1

2015 AUG 17 PM 3 13

Arizona Corporation Commission

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AUG 17 2015

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IN THE MATTER OF THE APPLICATION
OF EPCOR WATER ARIZONA, INC. FOR A
DETERMINATION OF THE CURRENT
FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR INCREASES
IN ITS RATES AND CHARGES FOR
UTILITY SERVICE BY ITS MOHAVE
WATER DISTRICT, PARADISE VALLEY
WATER DISTRICT, SUN CITY WATER
DISTRICT, TUBAC WATER DISTRICT,
AND MOHAVE WASTEWATER DISTRICT

DOCKET NO. WS-01303A-14-0010

EPCOR WATER ARIZONA
INC.'S EXCEPTIONS TO
RECOMMENDED OPINION
AND ORDER

I. INTRODUCTION

Pursuant to A.A.C. R14-3-110, EPCOR Water Arizona, Inc. ("EWAZ" or "Company") files the following exceptions to the Administrative Law Judge's Recommended Opinion and Order ("ROO") dated August 7, 2015. Although the Company supports and appreciates many of the findings in the ROO, certain findings in the ROO are not supported by the preponderance of the evidence in the record and should be modified.

These include the following:

1. Adopting a return on equity ("ROE") that does not accurately reflect the level of risk facing EWAZ and that is far below any return on equity adopted by the Commission for any Class A water utility in recent proceedings.

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ROTHGERBER

2. Rejecting the Company's reasonable request for inclusion in this case of twenty-four months of deferred depreciation and AFUDC.
3. Rejecting the Company's well-supported request for rate case expense.
4. Rejecting the Company's treatment of Accumulated Deferred Income Tax.
5. Requiring the Company to record a loss for flood damage to its Wishing Well Plant.

The Company also requests that rates approved in this proceeding be effective as of August 1, 2015, in accordance with the Commission's time clock rules.

To put the ROO in context, the Company initially sought a revenue increase of \$5,276,155. Following that filing, the Company worked closely with Commission Staff, RUCO, and the other intervenors in an effort to find common ground on positions taken by the parties. Through these discussions, the Company reduced its request by \$1 million. This revised amount included a reduction to the Company's cost of capital recommendation, adjustments to the incentive compensation request, acceptance of Staff's tank maintenance recommendation and acceptance of RUCO's recommendation for arsenic media replacement cost recovery. As a result, in its Final Schedules, the Company, after considerable concessions during the pendency of this proceeding, requested a total increase in annual revenues of \$4,242,376. As written, the ROO would provide a revenue increase of less than \$3.4 million, which is approximately 64 percent of the Company's initial request.

II. BACKGROUND ON ACCOUNTING ISSUES

The ROO describes in detail the Company's issues with its accounting records. As the Company described during this proceeding:

In February 2012, EPCOR Water USA ("EWUS") purchased Arizona American Water Company from American Water. At the time of the purchase, the Company was using JD Edwards accounting software and PowerPlant capital asset software to maintain its general ledger accounting and fixed asset (plant) accounting transactions, respectively. The

1 accounting software in use by EPCOR Utilities Inc. ("EUI"), the parent
2 company of EWUS, was ORACLE, which includes general ledger
3 accounting, fixed assets (plant), and inventory (IVARA) modules. All of
4 the existing accounting in place at the time of purchase had to be remapped
5 to the new ORACLE systems and the finance team (finance, accounting
6 and rates personnel) had to convert to using these new systems. In
7 addition, all of the fixed assets had to be remapped and uploaded into the
8 ORACLE fixed asset ("OFA") module.¹

9 This transition led to issues with the accounting information, and the Company has
10 accepted responsibility for those issues, agreeing to support a three month delay in the
11 proceeding. Following that delay, the Company, Commission Staff and RUCO came to
12 agreement on the starting balances for the Company's plant accounts. The Company
13 continues to appreciate the work done by Commission Staff and RUCO to work through
14 those issues. However, despite agreement of the parties on the starting balances for the
15 Company's plant accounts, and despite agreement on the three month delay, the ROO
16 relies upon these accounting issues as an unfounded and unsupported basis to reduce the
17 Company's return on equity and to reduce certain other requested and supported expenses.

18 III. COST OF CAPITAL

19 An appropriate cost of capital analysis must determine an ROE that is (i) similar to
20 the return in businesses with comparable risks; (ii) sufficient to ensure confidence in the
21 financial integrity of the utility; and (iii) sufficient to maintain and support the utility's
22 credit.² The ROO's recommended ROE of 8.9 percent, which is far below any ROE
23 approved by the Commission for a Class A utility in recent Commission decisions, fails to
24 meet any of these criteria.³ Rather, at a time when water scarcity and the need for
substantial and costly infrastructure replacement face the water industry, the ROO

¹ Exhibit ("Ex.") A-8 at 4. The decision to use Oracle was the most cost effective approach.

² *Bluefield Water Works & Improvement Co. v. Pub. Ser. Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923).

³ See, e.g., Decision No. 74081 (10 percent) (Arizona Water); Decision Nos. 73736, 73938, 74463 (10.55 percent) (Arizona Water); Decision No. 74568 (9.6 percent) (Chaparral City Water). As recently as the last Open Meeting, the Commission found that a 10 percent cost of equity (resulting in a 10 percent overall rate of return) was reasonable for a water utility. See Decision No. 75162 (Tonto Basin--Class C).

1 disregards the credit, business and economic risks facing the Company. Despite there
2 being ample support for the Company's recommended cost of equity of 10.55 percent, the
3 ROO ultimately relies upon Commission Staff's use of a single model, the DCF model, to
4 find that the Commission should grant an 8.9 percent return on equity.⁴ Finally, and
5 perhaps most troubling, without any support in the record and without establishing any
6 causal link, the ROO holds that the Company's accounting issues should result in a lower
7 ROE for the Company.⁵ This ROE would place the Company at a tremendous
8 disadvantage in competing for capital both regionally and nationally and would ultimately
9 raise the cost to customers in this uncertain economic climate.

10 Water utilities in the West, such as EPCOR, are facing serious challenges, including
11 water scarcity and the need for substantial and costly infrastructure replacement. Given
12 these challenges, the ROO's recommended 8.9 percent ROE is inadequate. The ROO's
13 recommendation is significantly less than approved ROEs of many other Class A utilities
14 in Arizona, as well as the authorized returns of water companies nationally, with which
15 EPCOR must compete for capital. The main reason that the ROO's recommendation is too
16 low is that it relies on a single ROE model rather than a consideration of the multiple
17 models used in setting ROE. The ROO also does not take into account the greater risks the
18 Company faces compared to other water companies seeking capital. These greater risks
19 require a higher return if EPCOR is to be competitive in the capital markets.

20 **A. Multiple Models Should Be Used to Determine the ROE**

21 Ms. Ahern, unlike Commission Staff, relied upon multiple models in her analysis,
22 which is consistent with the Efficient Market Hypothesis (upon which proper cost of
23 capital analysis is based), and which provided the Company's ROE analysis with diversity
24 and broad perspective.⁶ Despite this, and perhaps in spite of this, the ROO relies solely
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26 ⁴ ROO at 40-41.

⁵ *Id.* at 43.

⁶ Ex. A-32 at 19-41.

upon Commission Staff's single model (DCF) to determine that a cost of equity of 8.9 percent is appropriate. When all models are used, Ms. Ahern's conservative and unadjusted analysis resulted in a recommended base of 9.72 percent, prior to making needed adjustments for credit risk, business risk and economic risk.⁷ Following the proper consideration of these adjustments, the Company's analysis fully supports a recommendation of 10.55 percent as set forth below:⁸

<u>Proxy Group</u>	
Discounted Cash Flow Model	8.52%
Risk Premium Model	10.97%
Capital Asset Pricing Model	9.72%
Indicated Common Equity Cost Rate (before Adjustments)	<u>9.72%</u>
Credit Risk Adjustment	0.24%
Business Risk Adjustment	0.30%
Indicated Common Equity Cost Rate	<u>10.26%</u>
Recommended Common Equity Cost Rate (rounded)	<u>10.25%</u>
Adjusted to include one-half of Staff's 60 basis point economic risk adjustment	<u>10.55%</u>

B. Adjustments Must be Made to Address the Differences Between the Company and the Proxy Group and to Address Economic Conditions.

Each of the parties that submitted cost of capital testimony in this proceeding relied upon proxy groups to reach its recommendations.⁹ Although the proxy groups are composed of other water utilities, there are important differences between the proxy group and the Company. By failing to make any credit risk or business risk adjustment, the ROO ignores these differences. And, in this case, not only does the ROO fail to make these

⁷ Ex. A-33 at Ex. PMT RT-1, Sch.9.

⁸ *Id.*

⁹ ROO at 39; Ex. A-32 at 3.

1 appropriate adjustments, which are supported by the record, but it also ultimately
2 recommends an ROE that falls far below any authorized ROE for the utilities that make up
3 the proxy group.¹⁰

4 **1. Credit Risk Adjustment**

5 Based on an analysis of the differences between the Company and the proxy group,
6 the Company supported a credit risk adjustment of 24 basis points based on the Company's
7 likely bond rating compared to the proxy group.¹¹ Rather than addressing this
8 recommendation in detail, the ROO dismisses it without discussion. An examination of
9 the record, however, demonstrates that the Company's bond rating would likely be A-
10 (S&P), consistent with the bond rating of the Company's parent.¹² RUCO, in its briefing
11 and testimony, concedes this point:

12 The recent rating agencies reports and upgrades [are] an indication of the
13 business and financial strength of EWAZ's parent Company. The business
14 and credit risk of a wholly-owned, cost of service based, rate regulated
15 monopoly utility operating in the U.S. such as EWAZ is comparable to that
16 of its parent.¹³

17 If this is indeed the case, then an adjustment must be made to address the difference
18 between the credit risk of the proxy group and that of the Company, which Ms. Ahern
19 correctly found to be 24 basis points.

20 **2. Business Risk Adjustment**

21 In addition to the credit risk adjustment, a business risk adjustment of 30 basis
22 points is warranted based on the Company's small size compared to the proxy group.¹⁴
23 This adjustment is supported by Ibbotson, a well-respected source relied upon by Ms.
24 Ahern and by RUCO's cost of capital witness.¹⁵ Using her proxy group and the proxy

25 ¹⁰ See, e.g., Docket No. 14-0419 (Order dated Mar. 25, 2015) (Aqua Illinois Water) (9.81 percent); Docket No. 44450
(Order dated Jan. 1, 2015) (Indiana-American Water Co.) (9.75 percent); Docket No. WR13111059 (Order dated June
26 28, 2014) (Middlesex Water Company—New Jersey) (9.75 percent).

¹¹ Ex. A-33 at 31.

¹² Ex. A-32 at 43; Ex. A-34 at 58.

¹³ RUCO Opening Brief at 50 (citing Ex. R-32 at 16).

¹⁴ Ex. A-33 at 31.

1 group utilized by Commission Staff, as well as Ibbotson data relating to the size premia of
2 these proxy groups, Ms. Ahern calculates the business risk faced by the Company due to
3 its smaller size and recommended a 30 basis point adjustment.¹⁶

4 The ROO itself recognizes that “the distribution of actual returns is greater for a
5 small utility than for a large utility, and greater variability means greater risk.”¹⁷ And
6 greater risk, by definition, must lead to a greater investor required return. The Company’s
7 earned return on equity for the five years ending 2012 was 2.4 percent while the proxy
8 group’s was 8.26 percent.¹⁸ Similarly, for the same period, the Company’s funds from
9 operations as a percentage of total debt was 1.76 percent and the proxy group’s was 17.82
10 percent.¹⁹ In addition, if the actual ROEs of the Company and the proxy group are
11 examined, the Company’s ROE is much more variable than that of the proxy group.²⁰ This
12 evidence demonstrates that the Company is underperforming the proxy group and its ROE
13 is more variable, and therefore, warrants a finding of greater risk and the need for a
14 business risk adjustment.

15 3. Commission Staff’s Economic Risk Adjustment Should Be Used

16 This Commission has recognized Commission Staff’s economic risk adjustment of
17 60 basis points in multiple instances.²¹ This adjustment is not duplicative of the business
18 risk adjustment or credit risk adjustment. Unlike the two prior adjustments, which account
19 for the differences between the Company and the proxy group, this adjustment addresses
20 the risks faced by the water industry in totality.²² This adjustment is particularly needed in
21 light of the growing risks to the water industry in the West due to stressed water supplies,
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23 ¹⁵ Transcript (“Tr”) at 674.

24 ¹⁶ Id. at 674-75; Ex. A-33 at 30-31.

25 ¹⁷ ROO at 42.

26 ¹⁸ Ex. A- 32 at Ex. PMA DT-2, Sch. 4 at 2-3.

¹⁹ Id.

²⁰ Id. at Exhibit PMA-DT 2, Sch 4, at 1-2. An analysis of the data in that schedule demonstrates that the Company’s standard deviation from the proxy group was 2.67x and the coefficient of variation was 9.20x that of the proxy group.

²¹ Decision No. 74084 at 22; Decision No. 74294 at 53; Decision No. 74097 at 20-21.

²² Ex. S-8 at 39; Tr. at 693, 696, 705.

1 drought, shortages, and declining usage beyond the amount reflected in this case which
2 could expose the Company to revenue instability based on the proposed rate design.
3 Substantial infrastructure needs have been identified in several of the Company's existing
4 systems with over 70 miles of mains at the end of their useful life, which makes
5 maintaining a low cost of debt critical to help fund these needed improvements. These
6 risks are very real, as evidenced by potential CAP water shortages and water restrictions in
7 the western United States. Despite these risks, the ROO determines, without citation or
8 any record support, that the economic adjustment is no longer needed because the
9 economy has been slowly improving in a low interest rate environment.²³ This finding
10 fails to recognize the realities facing the water industry, particularly in Arizona and the
11 West.²⁴ These risks make Commission Staff's adjustment even more appropriate.

12 Interestingly, it is the low interest rate environment that the ROO relies upon which
13 has also resulted in unusually low ROE results from the models used by the parties. As
14 Commission Staff noted in its testimony, it determined that its CAPM model should not be
15 relied upon because the low interest rate environment has led to "unusually low cost of
16 equity estimates being obtained from the CAPM model."²⁵ The same can be said for
17 Commission Staff's DCF model, which is even more reason that it should not be relied
18 upon exclusively. In fact, another basis for adopting Commission Staff's economic
19 adjustment is a means to reflect that the current economic environment, particularly the
20 low interest rate environment, is unusual and is causing capital models to underestimate
21 ROEs.

22 **C. The ROO's Arguments against the PRPMTM Miss the Point**

23 The ROO ultimately dismisses Ms. Ahern's recommendation based in large part
24 upon its use of the PRPMTM model.²⁶ According to the ROO, the PRPMTM model should

25 ²³ ROO at 43.

26 ²⁴ Tr. at 705-06.

²⁵ Ex. S-8 at 5.

²⁶ ROO at 41.

1 not be relied upon because it has not been peer reviewed and because other parties were
2 not able to access the program or data upon which the results are based.²⁷ These
3 statements fail to account for the totality of Ms. Ahern's analysis. Ms. Ahern used
4 multiple models, which is appropriate for a cost of capital analysis. These include the
5 DCF model, CAPM model and the Risk Premium model. The PRPMTM is only one of the
6 sub-models used by Ms. Ahern in her Risk Premium analysis.

7 The Company does not rely solely upon the PRPMTM for its analysis. Rather, it is an
8 additional model that bolsters the Company's recommendation. As Ms. Ahern explained
9 during the proceeding, the PRPMTM "directly measures investors' assessment of risk by
10 evaluating the returns and equity risk premiums based upon the pricing decisions investors
11 make based upon their risk expectations."²⁸ Unlike the DCF and the CAPM, which
12 provide estimates of investor behavior based on certain assumptions, the PRPMTM
13 "directly assesses the outcomes of investor behavior."²⁹ In certain instances, those results
14 will be lower than other models and in certain instances those results will be higher than
15 other models. Investor behavior will control. And, contrary to the findings in the ROO,
16 the PRPMTM has been peer reviewed by influential and meaningful journals.³⁰ In addition,
17 with regard to the program and data used for this model, this data is publicly available and
18 offers were made to the parties to explain and to demonstrate the methodology, but those
19 offers were refused.

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23 ²⁷ *Id.*

24 ²⁸ Ex. A-33 at 54

25 ²⁹ *Id.*

26 ³⁰ These journals are academic journals and the peer reviewers are academicians (college professors / PhDs). This includes both Robert F. Engle's work on the GARCH methodology, as well as the articles regarding the PRPM. *See* Ex. A-33 at 52-53. These articles have never been rebutted in an academically peer reviewed or non-peer reviewed journal. *Id.* at 53. The GARCH model as applied to public utilities was published in both *The Journal of Regulatory Economics* (December 2011) and *The Electricity Journal* (May 2013). Both journals are academically peer reviewed.

D. Forward-Looking Data Should Be Used in Determining an Appropriate ROE

It is undisputed that investors, who make decisions based on expected benefits, are forward looking.³¹ Cost of capital, including the cost of equity cost rate, “is expectational in that it reflects investors’ expectations of future capital markets, including an expectation of interest rate levels, as well as risks.”³² Ratemaking is also prospective as rates are set for future periods. In countering the Company’s position, the ROO finds that it is appropriate to use both forward-looking and historical data. However, projections of earnings and risk free rates are more appropriate than historical results because investors act based on expectations of future results. In addition, historical results already factor in expected future results, so the use of historical data directly as proposed by the ROO results in double counting of the historical data.

E. There is No Link Between the Company’s Accounting Issues and the ROE

In its final conclusion in support of an 8.9 percent ROE, the ROO holds that the Company’s accounting issues “are properly considered in determining EPCOR’s cost of equity in this proceeding.”³³ This punitive finding cannot stand. There is no evidence in the record, nor could there be, to support an ROE adjustment based upon accounting difficulties.

For all of these reasons, the Commission should adopt the Company’s recommended cost of capital of 10.55 percent. A proposed amendment regarding ROE is attached as Exhibit A.

IV. 24-MONTH DEFERRAL OF DEPRECIATION AND AFUDC

Commission Staff, RUCO, and now the ROO, claim that the Company should not be granted a 24-month deferral if it is also granted a SIB mechanism. Although both, at

³¹ Ex. A-34 at 19.

³² Ex. A-33 at 34.

³³ ROO at 43.

1 least in part, seek to address regulatory lag, they are not duplicative and seek to address
2 different issues. As repeated throughout this proceeding, and contradicted by no party to
3 this proceeding, approval of the Company's request in this case for a 24-month deferral
4 includes no costs recovered through the use of the proposed SIB mechanism. The SIB
5 mechanism is limited to replacing mains, meters, hydrants, services, and valves. The
6 Company's request for a 24-month deferral primarily encompasses other types of
7 investment such as wells, treatment facilities, and storage tanks.³⁴

8 The ROO is correct that the Company's request is based on Commission Staff's
9 2012 Report and seeks to accomplish the same goals set forth in Commission Staff's
10 proposal: (1) mitigate "the effects of carrying costs of net plant additions between rate
11 proceedings" and (2) mitigate the impact of depreciation expense that the Company must
12 begin to record without recovery on plant that is put into service between rate cases.³⁵
13 Nowhere in Commission Staff's proposal does it state that only one tool can or should be
14 used to address regulatory lag.

15 Recognition of the impacts of this regulatory lag on the Company and approval of
16 the Company's 24-month deferral request in rates would allow for the recovery of the
17 deferred carrying costs (AFUDC) and depreciation throughout the test year, beginning
18 more than three years ago on the first day of the test year, which in this case is July 1,
19 2012.³⁶ As requested by EWAZ, the deferred amount would include AFUDC and
20 depreciation on plant placed in service throughout the test year and for the following 12
21 months (*i.e.* the 24-month period requested here).³⁷ In this case, that deferral period ends
22 on June 30, 2014. Accordingly, putting aside the differences in the plant that is part of this
23 request, given different periods, there can be no overlap with the Company's SIB request.
24

25 _____
³⁴ Ex. A-8 at 17.

26 ³⁵ Ex. A-38 at 2-3.

³⁶ Ex. A-8 at 7, 18.

³⁷ *Id.* at 16.

The ROO also finds that this deferral request cannot be backward looking and that the Company should have sought Commission authority in advance for the deferral.³⁸ In fact, the Company did so, and both the Commission Staff and RUCO argued that this request should be handled in the context of a rate case.³⁹

The impact of the regulatory lag experienced by the Company can be demonstrated by looking at the cost of \$1 million dollars of investment placed in service when a rate decision is issued 24 months after the first day of the test year. For every \$1 million of investment at a 6.81 percent cost of capital (debt and equity as requested by the Company), and a composite depreciation rate of approximately 3 percent, the annual lost revenue to the Company is approximately \$157,000 of revenue, or \$13,080 per month.⁴⁰

As set forth in the Company's Final Schedules, EWAZ's deferral request in this case is in the amount of \$1,666,289, with a requested amortization of \$49,660.⁴¹ These amounts reflect actual additions to plant during the 24-month deferral period commencing July 1, 2012 and ending June 30, 2014. The following table shows the impact of this deferral on a per district basis.

	<u>Mohave W</u>	<u>Mohave WW</u>	<u>Sun City W</u>	<u>PV</u>	<u>Tubac</u>	<u>Total</u>
24-Month Deferral (addition to rate base)	\$763,868	\$ 89,523	\$392,361	\$397,156	\$23,381	\$1,666,289
Amortization of 24-Month Deferral	\$20,234	\$2,587	\$12,639	\$13,543	\$657	\$49,660

A proposed amendment to adopt the Company's deferral request is set forth in Exhibit B.

V. RATE CASE EXPENSE

The ROO relies upon two arguments to find that the Company's rate case expense should be reduced from \$650,000 to \$325,000, as recommended by RUCO. First, the

³⁸ ROO at 28.

³⁹ See Procedural Order dated July 2, 2013, Docket Nos. SW-01303A-12-0427 *et al.*

⁴⁰ *Id.* at 15.

⁴¹ Company's Schedules. These amounts would need to be adjusted based on the cost of capital of the decision.

1 ROO relies upon the delays in the case caused by the Company's accounting issues.⁴²
2 Second, the ROO relies upon one accounting entry in the Paradise Valley District, the
3 recovery of which the ROO ultimately concludes is appropriate.⁴³ As noted in the ROO,
4 Commission Staff did not take issue with the Company's rate case expense request in its
5 briefing.

6 As noted above, the Company accepts responsibility for its accounting issues.
7 However, a \$325,000 reduction as proposed by the ROO does not accurately reflect the
8 impact of those accounting issues. As noted in the ROO, the Company is not seeking to
9 recover any more than the amount of expenses actually incurred for rate case expense.⁴⁴ In
10 fact, to date, the Company has incurred more than \$800,000 in rate case expense in this
11 case. It is improper to find that three months of delay caused by the Company's
12 accounting records resulted in a doubling of the Company's rate case expense. The
13 Company filed this case approximately 17 months ago and the preparation of the case
14 commenced well in advance of that filing date. Even if the three months of delay is
15 eliminated from the Company's request, it is still reasonable to allow the Company at least
16 5/6 of its request (15 of the 18 months of processing).

17 As demonstrated by the breadth of issues raised by the multiple parties to this case,
18 this is a complex case with multiple issues. And, although much of the discussion in the
19 case involved the Company's debit and credit accumulated depreciation balances, the ROO
20 ultimately found those balances to be appropriate and in compliance with the group
21 method of accounting.⁴⁵ The Company's rate case expense should not be reduced because
22 it defended its position on these accounting entries.

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25 _____
26 ⁴² ROO at 35.

⁴³ *Id.* at 24-25, 35.

⁴⁴ Ex. A-11 at 8.

⁴⁵ ROO at 21-25.

1 As such, the Company respectfully requests that the Commission adopt an
2 amendment modifying the approved rate case expense. A proposed amendment is attached
3 as Exhibit C.

4 **VI. ACCUMULATED DEFERRED INCOME TAX ("ADIT")**

5 The ROO adopts RUCO's position in relation to accumulated deferred income tax
6 ("ADIT") and reduces the Company's rate base accordingly.⁴⁶ As noted in the ROO,
7 ADIT results from a difference between the time income taxes are recognized for
8 ratemaking purposes and when actual federal and state tax obligations are incurred.⁴⁷
9 However, the bonus depreciation available to the Company also created a net operating
10 loss ("NOL") for the Company on its 2013 tax return.⁴⁸ As a result, the actual impact of
11 the bonus depreciation for the Company is nullified by the deferred tax asset generated by
12 the NOL, and therefore, should not be used as an adjustment to rate base as proposed by
13 the ROO. The ROO, in part, relies upon the testimony of RUCO's witness that the IRS
14 has "issued three Private Letter Rulings in 2014 that indicate the IRS considers regulators'
15 recognition of ADIT credits in rate base when such recognition results in an NOL to be
16 normalization compliant."⁴⁹ A closer review of those Private Letter Rulings, particularly
17 the most recent rulings, shows that this is not correct.⁵⁰ In Private Letter Ruling
18 201438003, the IRS in fact found as that the failure to include the deferred taxes related to
19 a net operating loss carry-forward (NOLC), would be inconsistent with the normalization
20 requirements:

21 Under the circumstances described above, the reduction of Taxpayer's rate
22 base by the full amount of its ADIT account balance unreduced by the
23 balance of its NOLC-related account balance would be inconsistent with

24 ⁴⁶ ROO at 33-34.

25 ⁴⁷ *Id.*

25 ⁴⁸ ROO at 33; Ex. A-9 at 17.

26 ⁴⁹ ROO at 34.

26 ⁵⁰ As noted by RUCO, in one Private Letter Ruling in 2014 on this issue, the IRS did find that a reduction based on
the NOL would not be normalization compliant. See Private Letter Ruling No. 201418024 (released May 2, 2014)
(available at <http://www.irs.gov/pub/irs-wd/1418024.pdf>).

1 the requirements of §168(i)(9) and §1.167(l)-1 of the Income Tax
2 regulations.⁵¹

3 In another Private Letter Ruling issued in 2014, PLR 201436037, the IRS made a similar
4 finding.⁵² Finally, in its most recent Private Letter Ruling, the IRS again found that a
5 reduction in rate base without the inclusion of the NOL is not normalization compliant and
6 in fact inconsistent with IRS regulations.⁵³

7 The Company continues to believe that its approach to ADIT, which recognizes its
8 NOL, is appropriate and in compliance with normalization requirements. A proposed
9 amendment is attached as Exhibit D.

10 **VII. FLOOD DAMAGE TO WISHING WELL PLANT**

11 Although not suggested by any party to this proceeding, the ROO recommends that
12 the Company be required to recognize as a loss the amount of the Wishing Well Plant
13 retired early as a result of flooding.⁵⁴ The Company could have insured this plant and all
14 other plant with a zero deductible; however, the cost to do so would have been extremely
15 high and ultimately borne by ratepayers. Accordingly, the Company wisely chose a
16 commercially-reasonable, higher deductible. That higher deductible applied to all of the
17 Company's operations, and the resulting lower operating expenses are reflected in the
18 Company's rates for all of its utility districts and benefit all of the Company's customers.
19 The Company, which made a reasonable and responsible decision, should not now be
20 required to recognize a loss on this plant without any associated recovery from customers
21 as recommended in the ROO. The debit balance in accumulated depreciation for this early
22

23 ⁵¹ Private Letter Ruling No. 201438003 (released Sept. 19, 2014) (available at <http://www.irs.gov/pub/irs-wd/201438003.pdf>). The Company recognizes that Private Letter Rulings are intended for the taxpayer to which they
24 are directed and are not precedent setting. However, to the extent that RUCO and the ROO relied upon prior Private
25 Letter Rulings, it is important to understand and recognize the IRS' correct and most recent position on this issue.

⁵² Private Letter Ruling No. 201436037 (released Sept. 5, 2014) (available at <http://www.irs.gov/pub/irs-wd/201436037.pdf>).

26 ⁵³ Private Letter Ruling No. 201436037 (released Sept. 5, 2014) (available at <http://www.irs.gov/pub/irs-wd/201519021.pdf>).

⁵⁴ ROO at 24.

retirement due to flood damage should be reclassified to a regulatory asset account and amortized at a rate of 8 percent similar to the recommendation in the ROO regarding other debit balances in accumulated depreciation.

A proposed amendment is attached as Exhibit E.

VIII. EFFECTIVE DATE OF NEW RATES

The time clock in this proceeding expired July 29, 2015.⁵⁵ This date includes the delay in the hearing discussed above, as well as additional days added for each day of hearing in this matter. The Company requests that the Commission adopt an effective date for new rates approved in this proceeding of August 1, 2015, in accordance with the time clock requirements. To accomplish this modification, the Company requests that the Commission amend the effective date set forth on page 79 of the ROO.⁵⁶

IX. PROOF OF REVENUES

Based on its review of the ROO, the Company has determined (as set forth in the table below) that the proposed rates would under collect the ROO's revenue requirement by approximately \$200,000. In the final Decision in this matter, the Company respectfully requests that the rates be revised to address this under-collection.

	<u>Present Revenues</u>	<u>Gross Revenue Increase per ROO</u>	<u>ROO Revenue Requirement</u>	<u>Proof of Revenues</u>	<u>Difference</u>
Mohave Wastewater	\$ 1,055,840	\$ 368,544	\$ 1,424,384	\$ 1,424,572	\$ 189
Mohave Water	\$ 6,389,776	\$ 1,598,040	\$ 7,987,816	\$ 7,867,954	\$ (119,862)
Sun City Water	\$10,295,663	\$ 1,040,530	\$11,336,193	\$ 11,231,346	\$ (104,847)
Paradise Valley Water	\$ 9,648,251	\$ 168,255	\$ 9,816,506	\$ 9,849,621	\$ 33,115
Tubac Water	\$ 579,194	\$ 239,177	\$ 818,371	\$ 809,569	\$ (8,803)
Total			<u>\$31,383,270</u>	<u>\$ 31,183,062</u>	<u>\$ (200,208)</u>

⁵⁵ AAC R14-2-103.B.11.

⁵⁶ Given the hearing of this matter on August 27, 2015, the Company requests that the Company be given a time period tied to the effective date of the Decision to file updated tariffs. Currently, the required date is August 31, 2015 in the ROO.

1 **X. ADDITIONAL ISSUES**

2 **A. Creation of Regulatory Liability**

3 Although agreeing with the Company's depreciation methodology and making no
4 finding that the Company applied any incorrect depreciation rates, the ROO agrees with
5 RUCO that it is appropriate for the Company to reclassify all account/group that currently
6 have accumulated depreciation balances that are greater than the associated plant balances
7 to regulatory liabilities.⁵⁷ In addition, the ROO would also require the Company to refund
8 the amounts reclassified as regulatory liabilities to customers at a rate of 8 percent per year
9 until fully refunded. The refund to customers of depreciation expense accumulated in
10 accordance with prior Commission orders setting the Company's depreciation rates
11 constitutes retroactive ratemaking. Accordingly, the Company disagrees with the
12 recommendation in the ROO.

13 **B. Low Income Amortization**

14 The ROO adopts Commission Staff's recommendation to amortize regulatory
15 liabilities for Mohave Water of \$106,450 and Sun City Water of \$90,329 related to low
16 income programs that were not fully subscribed and resulted in over collection.⁵⁸
17 Although the Company agrees with the this recommendation, it does not believe that the
18 calculation of present revenues in the ROO at page 76 (lines 13-18) accounts for the
19 change to present revenues, which would lead to a reduction in the revenue requirement.

20 The table below shows the comparison of the present revenues used to calculate the
21 Operating Income to the Company's Final Schedules, which demonstrates that the
22 amortization may not have been accurately included.

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⁵⁷ ROO at 23.

⁵⁸ ROO at 29.

District	Present Revenue ROO at 44-45	Present Revenue Company Final	Difference	Explanation of Difference
Sun City Water	\$10,265,553	\$10,295,663 ¹	\$30,110	\$30,110 - Low Income Amortization
Mohave Water	\$ 6,354,293	\$ 6,389,776	\$35,483	\$35,483 - Low Income Amortization
¹ Adjusted to remove Adj SM-13R of \$14,255				

XI. CONCLUSION

For the reasons set forth above, the Company respectfully requests that the Commission adopt the amendments and modifications proposed by the Company in these Exceptions.

RESPECTFULLY SUBMITTED this 17th day of August, 2015.

LEWIS ROCA ROTHGERBER, LLP



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Attorneys for EPCOR Water Arizona, Inc.

ORIGINAL AND thirteen (13) copies
of the foregoing hand-delivered this
17th day of August, 2015, to:

The Arizona Corporation Commission
Utilities Division – Docket Control
1200 W. Washington Street
Phoenix, Arizona 85007

Copy of the foregoing hand-delivered
this 17th day of August, 2015, to:

Thomas M. Broderick
Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Dwight D. Nodes, Chief Administrative
Law Judge
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

- | | | |
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EXHIBIT A
AMENDMENT

DELETE Pg. 41, line 16 through page 43, line 13, and INSERT the following:

EPCOR's recommended cost of equity calculation of 10.55% is reasonable in this case. EPCOR's recommendation, which is based on multiple models, is consistent with the Efficient Market Hypothesis. EPCOR's unadjusted cost of equity of 9.72% is less than the cost of equity approved in other Class A utility rate cases before the Commission, but the three adjustments proposed by EPCOR are reasonable and supported by the evidence and increase the cost of equity to an appropriate level. The credit risk adjustment of 24 basis points is also appropriate because EPCOR's credit rating is lower than the other members of the proxy group. The business risk adjustment of 30 basis points, supported by the Ibbotson study, is appropriate because EPCOR is smaller than the other members of the proxy group and thereby faces more risk. Finally, EPCOR's use of a 30 basis point economic assessment adjustment (50% of Staff's proposed 60 basis point economic assessment adjustment) is justified by the risk faced by water companies in the southwestern United States. Accordingly, we determine the cost of equity to be 10.55%.

MAKE CONFORMING CHANGES

EXHIBIT B
AMENDMENT

DELETE Pg. 28, line 10 through line 26 and INSERT the following:

The Company's request is based on the Commission Staff's 2012 Staff Report in which Commission Staff recommend this 24 month deferral approach in an effort (1) to mitigate "the effects of carrying costs of net plant additions between rate proceedings" and (2) to mitigate the impact of depreciation expense that a utility must begin to record without recovery on plant that is put into service between rate cases. We agree with Commission Staff's goals in that Report and believe this is an appropriate mechanism to address regulatory lag. In addition, given the time period of the deferral in this case, there is no possibility of overlap with amounts sought as part of the SIB mechanism.

The evidence in this case demonstrates that the Company's request to include \$1,666,289 is reasonable and will account for an annualized deferred debit of \$49,659. These amounts are supported by the amortization and actual depreciation rates by account. We find the Company's request to be reasonable and will adopt it here.

MAKE CONFORMING CHANGES

EXHIBIT C
AMENDMENT

DELETE Pg. 35, line 5 through page 35, line 26 and INSERT the following:

We are cognizant of the Company's accounting issues, which led the Company to refile its schedules in October 2014, resulting in a three month continuance of the hearing and a delay in the ultimate processing of this decision. We do not agree, however, that these accounting issues and the three month delay in the proceeding should result in a 50% reduction in the Company's rate case expense as recommended by RUCO. As demonstrated by the complexity of this decision, this was not a simple proceeding, but rather a proceeding with multiple parties and many difficult issues. Many of these issues involved the Company's accounting, but ultimately we have determined that the Company complied with the group depreciation method in its accounting methodology.

Accordingly, we find the Company's request for rate case expense to be reasonable in this case.

MAKE CONFORMING CHANGES

EXHIBIT D
AMENDMENT

DELETE Pg. 34 lines 15 through 23 and INSERT the following:

In this case, bonus depreciation resulted in an NOL as part of EPCOR's 2013 federal consolidated income tax return. As a result, the impact of the bonus depreciation is nullified by the NOL. Accordingly, we do not adopt the reduction to rate base for ADIT recommended by RUCO.

MAKE CONFORMING CHANGES

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EXHIBIT E
AMENDMENT

DELETE pg. 24, lines 8 through 17.

MAKE CONFORMING CHANGES.